

**ANNUAL REPORT
OF THE
LOCAL GOVERNMENT FINANCE
STUDY COMMISSION**



**Indiana Legislative Services Agency
200 W. Washington Street, Suite 301
Indianapolis, Indiana 46204**

December, 1998

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1998

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November, 1998

I. STATUTORY AND LEGISLATIVE COUNCIL DIRECTIVES

The Local Government Finance Study Commission was established by P.L.242-1997 to review laws affecting local government finance in Indiana. The Commission was first established in 1992, and it was re-established in 1994 and then again in 1997. It is set to expire in November of 2001.

P.L.242-1997 charged the Commission with the following duties:

(1) Conducting a study of matters concerning local government, including the following:

(A) Ways to simplify and recodify statutory property tax controls.

(B) Revenue sources and uses of the revenue.

(C) The impact of property tax controls on economic development.

(D) Alternative sources of revenue that are not derived from property taxes.

(E) Substantive changes to the Barrett Law.

(2) Conducting a special inquiry into the financial organization of local government.

The Commission may also study other topics assigned by the Legislative Council or as directed by the chairman of the Commission.

During the 1998 interim, the Legislative Council did not assign any specific topics to the Commission for study. The Commission determined that it would study the following topics during the 1998 interim:

(1) Issues related to the restructuring of Indiana's tax system.

(2) Property taxation of inventory.

(3) Property tax controls on civil taxing units.

(4) Taxation of railroad car companies.

(5) School general fund property taxes.

(6) State and local expenditure and revenue issues.

II. INTRODUCTION AND REASONS FOR STUDY

A. Issues related to the restructuring of Indiana's tax system

During recent sessions of the General Assembly, there has been much discussion concerning proposals that would significantly restructure Indiana's system of local government finance. The Citizens' Commission on Taxation appointed by Governor O'Bannon has been charged with developing revenue-neutral proposals to reduce property taxes. The members of the Citizens' Commission on Taxation have also been preparing for Governor O'Bannon a list of tax restructuring options and the costs and benefits associated with those options. In addition, the Indiana Supreme Court is in the process of deciding the *Town of St. John* case, which involves a constitutional challenge to Indiana's "true tax value" system of property tax assessment. The Commission therefore decided that it would be useful to hear testimony on issues related to tax restructuring.

B. Property taxation of inventory

Under existing law, property taxes are imposed on business inventory in Indiana. Indiana is one of only a handful of states that impose property taxes on inventory. Many economists, business owners, and others assert that the inventory tax is one of the most harmful taxes in terms of its effects on economic development. The Commission decided to study the property taxation of inventory in order to assess its effect on economic development in Indiana.

C. Property tax controls on civil taxing units

Existing Indiana law provides a complex system of limits on the property tax levies that may be imposed by units of local government. Many people assert that this system of property tax limitations has not adequately restricted the growth of property taxes in Indiana. The Commission therefore decided to take testimony on the efficacy of Indiana's property tax limits and also to hear testimony on proposed changes to those property tax limits.

D. Taxation of railroad car companies

Existing Indiana law provides that the indefinite-situs distributable property of railroad car companies is assessed on a statewide basis according to a statutory formula. The indefinite-situs property tax is collected by the Department of Revenue and deposited in the Commuter Rail Service Fund for use by the Northern Indiana Commuter Transportation District ("NICTD") as a source of funding. Railroad car companies and others assert that Indiana's indefinite-situs tax provides a disincentive that deters

railroad car companies from bringing railroad cars into Indiana for repair or maintenance. In addition, Indiana's indefinite-situs tax has been challenged under the federal "4R Act", which regulates property taxation of railroad companies. The Commission studied this topic in order to address the economic disincentives of the indefinite-situs tax and to find a potential source of funding for NICTD if the indefinite-situs tax is struck down under the federal law.

E. School Property Taxes

According to projections, approximately \$1.5 billion in school general fund and transportation fund property taxes will be paid in 2000. Because the elimination of school general fund property tax levies has been an issue before the General Assembly during past sessions, the Commission decided to examine the topic and discuss potential sources of replacement revenue that would be needed if school property taxes were eliminated.

F. State and Local Expenditures and Revenue

In 1989 total state appropriations were approximately \$8.224 billion, but by 1998 they had increased by \$5.625 billion to approximately \$13.849 billion. This amounts to a 68% increase in appropriations during the past ten years, while the Consumer Price Index has increased only 39% during that period. At the local level, property tax revenue has increased 166% during the period 1982 through 1997. The Commission decided to hear testimony concerning the amount and the rate of growth of state and local spending and taxation and to hear a proposal concerning limits on the growth of state expenditures.

III. SUMMARY OF WORK PROGRAM

The Commission held five meetings during the interim following the conclusion of the 1998 Session of the General Assembly. All five meetings were held at the State House in Indianapolis.

The first meeting of the Commission during the 1998 interim was held on July 9, 1998. This meeting of the Commission was devoted to an introduction and discussion of the issues that the Commission planned to study during the 1998 interim. At this meeting, the Commission also heard a staff report describing the Commission's activities and recommendations since its creation in 1992.

The second meeting of the Commission was held on July 21, 1998. The Commission heard testimony on and discussed the activities of the Citizens' Commission on Taxation appointed by Governor O'Bannon. At this meeting the Commission also heard extensive testimony on issues related to property taxation of business inventory.

The third meeting of the Commission was held on September 15, 1998. The Commission heard testimony on property tax controls in Indiana. The voting members of the Commission voted to recommend proposed drafts: (1) providing a credit against state taxes for property taxes paid; and (2) amending the Indiana Constitution to allow the General Assembly to exempt inventory from property taxation. In addition, the Commission heard testimony on the issue of property taxation of railroad car companies and the distribution of that property tax revenue.

The fourth meeting of the Commission was held on October 28, 1998. The Commission heard testimony on issues concerning: (1) the elimination of school property taxes and the replacement of that revenue; and (2) the taxation of railroad car companies.

The fifth and final meeting of the Commission was held on November 18, 1998. The Commission heard testimony on issues concerning: (1) state and local expenditures and revenue; (2) taxation of railroad car companies; and (3) school general fund and transportation fund taxes.

At its fifth meeting, the voting members of the Commission voted to: (1) recommend a proposed draft concerning taxation of railroad car companies; and (2) recommend that as part of any discussions concerning tax restructuring, the General Assembly should also consider the option of: (A) authorizing a local income tax for education; and (B) eliminating school general fund and transportation property tax levies. The Commission also voted to adopt its final report for the 1998 interim.

IV. SUMMARY OF TESTIMONY

A. FIRST MEETING (July 9, 1998):

The Commission's staff provided an overview of the significant issues studied by the Commission since its creation in 1992 and a summary of the Commission's findings and recommendations. The Commission's staff also distributed and discussed certain reports and exhibits prepared as background material to assist the Commission in its deliberations during the 1998 interim.

B. SECOND MEETING (July 21, 1998):

Restructuring of Indiana's Tax System

The Commission heard testimony from Professor Larry DeBoer, of Purdue University, who had been working as staff for the Citizens' Commission on Taxation. Professor DeBoer made the following points in his testimony:

(1) the Citizens' Commission intends to put together for the Governor a "briefing book" that includes a list of tax restructuring options and the costs and benefits associated with those options;

(2) the Governor had charged the Citizens' Commission with making revenue-neutral proposals to reduce property taxes; and

(3) the two basic issues facing the Citizens' Commission were how to reduce property taxes and what revenue would replace the lost property tax revenue.

Professor DeBoer also testified that property taxes could be reduced in a number of ways, such as reducing the types of government services funded by property taxes (e.g., removing welfare expenditures or school general fund expenditures from property tax funding); removing some types of property -- for example, business inventory -- from the property tax base; providing targeted tax relief to particular groups (e.g., providing relief to homeowners by increasing the homestead credit); or providing an equal percentage reduction in all taxpayers' property tax liability.

Professor DeBoer stated to the Commission that the state sales tax and the state income tax are the only existing taxes that could raise enough revenue to replace a significant amount of property tax revenue. He also noted in his testimony that some members of the Citizens' Commission had suggested that, notwithstanding the Governor's charge concerning revenue neutrality, the Citizens' Commission should advocate restricting the growth of state and local spending and using the money that is saved to replace property tax revenue.

Professor DeBoer made the following additional points in his testimony:

(1) there are a number of issues to think about when considering tax restructuring, such as the stability of the various taxes, the effect that particular taxes would have on economic development, and who will pay the various taxes;

(2) the property tax is the most stable of Indiana's taxes, while the corporate adjusted gross income tax and the supplemental net income tax are the least stable;

(3) business pays approximately 61% of Indiana property taxes and individuals pay the greatest shares of state sales and income taxes;

(4) if the property tax is replaced by sales and income tax revenue, there would be a shift in some of the tax burden from business onto individuals; and

(5) it is important to look behind the statutory incidence of taxes (that is, who actually pays the tax) to the economic incidence of those taxes (that is, to whom

are the costs ultimately passed).

Professor DeBoer also briefly described the history of the *Town of St. John* case, which involves constitutional challenges to Indiana's current "true tax value" method of property tax assessment. He explained that:

- (1) the plaintiffs filed their lawsuit in September of 1993;
- (2) the Indiana Tax Court in May of 1996 held the current method of property tax assessment unconstitutional on the grounds that the Indiana Constitution required a fair market value method of assessment;
- (3) the Indiana Supreme Court in December of 1996 had, after deciding that the Indiana Constitution did not require a fair market value method of assessment, overturned the Tax Court's decision and remanded the case to the Tax Court;
- (4) the Tax Court held in December of 1997 that although the Indiana Constitution may not require a fair market value method of assessment, the current true tax value method of assessment violates the Indiana Constitution; and
- (5) the Indiana Supreme Court had scheduled oral arguments in the appeal of the Tax Court's latest decision for September of this year.

Professor DeBoer noted that a change in the property tax assessment system from the current true tax value method to a fair market value method would cause a large shift in the property tax burden onto homeowners.

Property Taxation of Inventory

Mr. William Styring of the Hudson Institute testified that Indiana is one of only a handful of states that impose property taxes on inventory, and he noted that there is widespread agreement among economists that the inventory tax is one of the most harmful taxes in terms of its effects on economic development.

Mr. Styring made the following points during his testimony:

- (1) during the 1960s many economists thought that the state and local tax structure had little effect on business location, but recent studies with improved methodology show that considerations of state and local taxes are in fact important in business location decisions; after a decision concerning what region to locate in has been made, even small differences in state and local taxes can be important in the determination of the exact location of a new or expanding business;

(2) because of its location, Indiana would generally be considered a good place to locate distribution centers, but the fact that Indiana is one of few states to tax inventory has led to fewer distribution centers operating in Indiana than would otherwise be expected; nearby states do not tax inventories, and inventory is a very mobile factor of production; and

(3) studies have shown that if Indiana were to provide a credit against 50% of the inventory taxes paid by business, within seven years the state tax revenue generated by increased employment and investment would more than offset the lost property tax revenue; other studies have concluded that the lost property tax revenue would be offset even sooner.

In response to questions from Commission members concerning how many jobs or opportunities for new jobs have been lost because of the inventory tax, Mr. Styring answered that probably tens of thousands, possibly even hundreds of thousands of jobs or job-creation opportunities have been lost.

The Indiana Director of the National Federation of Independent Business ("NFIB") also testified before the Commission concerning the property tax on inventory. He made the following points in his testimony:

(1) in the 1960s, Indiana conducted one of the first major studies of the problems associated with the inventory tax; when the study was done, only twelve states had taken any action to reduce or eliminate inventory taxes, but now, thirty years later, Indiana is one of only eleven states that have not taken such action;

(2) although it is difficult to quantify the negative effects that the inventory tax has on employment growth and investment, its impairment of economic development can nonetheless be shown through anecdotal evidence;

(3) the inventory tax is especially hard on small business, and the NFIB's annual surveys of Indiana small businesses show that they regard it as their biggest problem;

(4) it is widely believed that approximately 85% of job growth comes from existing business and that the majority of this growth is attributable to small business;

(5) the General Assembly has created effective incentives to encourage job creation in Indiana, but by not taking any action to reduce or repeal the inventory tax the General Assembly has left in place the biggest obstacle to economic development; and

(6) the Uniformity Clause of the Indiana Constitution would most likely have to

be amended before the inventory tax could be repealed outright.

In response to questions from the Commission, the NFIB's Indiana Director answered that the problems that had prevented progress on inventory tax relief were the difficulty in finding replacement revenue, the potential constitutional issues, the lack of understanding of the issues involved, and the politicization of the issue.

A number of Commission members stated their views that the inventory tax is an especially unfair tax when applied to agriculture, and that individual agricultural producers have enough difficulty finding any competitive advantages, without facing the added burden of the inventory tax.

C. THIRD MEETING (September 15, 1998):

Property Tax Controls

The chairman of the Committee to Restore Indiana Property Tax Controls ("CRIPTC") testified concerning Indiana's system of property tax controls. He made the following points during his testimony:

- (1) the growth in property taxes has been greater than the growth in other major Indiana taxes;
- (2) the numerous attempts to limit or in some way replace property taxes over the last 25 years did not address the structural problems and have not resulted in a permanent solution;
- (3) structural problems leading to excessive growth in property taxes include: (i) the fact that most units of local government determine their budgets first and then determine the property tax rates needed to furnish the revenue necessary for those budgets; (ii) the current statutory system allows a minimum increase of 5% in civil units' maximum levies; (iii) because of the number of taxing units and the complexity of the budget-making process and the property tax levy limits, it is difficult for citizens to participate in a meaningful way; and (iv) many of the property tax notices, forms, and bills are difficult for an ordinary taxpayer to understand; and
- (4) to address structural problems in Indiana's property tax system, the following changes must be made: (i) the budgets of local governments should be based on available revenue, rather than having the revenue determined by a budget that is adopted first; (ii) the statutory property tax levy limits should be replaced by a local control board, consisting of various local elected officials, that has the authority to approve or deny any proposed property tax rate increases.

A representative of the Indiana Chamber of Commerce testified concerning the following:

- (1) property taxes are the fastest growing source of revenue in Indiana;
- (2) in real terms the level of Indiana property taxes is higher now than it was before the 1973 reforms;
- (3) Indiana is one of only ten states that imposes a property tax on inventory;
- (4) according to a Ball State University study, if Indiana shifted \$1 billion from property taxes to sales taxes, within five years state gross domestic product would increase by \$560 million, tax revenue would increase by \$47 million, and employment would increase by more than 5,000 jobs;
- (5) if property tax levies are merely lowered or limited to a certain percentage, the amount of those levies will likely increase again over time;
- (6) even if the structural flaws of the property tax system are not addressed, the minimum 5% growth factor contained in the property tax control statutes should be lowered and then somehow indexed to inflation; and
- (7) the Chamber of Commerce supports the CRIPTC proposal.

Property Taxation of Inventory

The Commission also discussed two proposed drafts concerning property taxation of inventory. The first draft, PD 3050, would phase-in over ten years a credit against state taxes for property taxes paid by the taxpayer. The second draft, a proposed joint resolution, would amend the Indiana Constitution to allow (but not require) the General Assembly to enact a law exempting inventory from property taxation.

In discussing this issue, a number of Commission members pointed to the economic development disincentives caused by property taxation of inventory. Certain Commission members also stated that a credit for inventory taxes paid would lead to increased economic growth, which would translate into more state revenue that within five to ten years would make up the revenue lost due to the credit.

In discussions concerning the proposed amendment to the Indiana Constitution, some Commission members noted that they would prefer an amendment to the Indiana Constitution that included an outright prohibition against property taxes on inventory, rather than merely giving the General Assembly the authority to eliminate those taxes.

Both the proposed tax credit and the proposed constitutional amendments were approved by 6-0 votes.

Taxation of Railroad Car Companies; Distribution of Tax Proceeds

At its third meeting, the Commission also discussed issues related to the indefinite-situs property tax paid on rolling stock of railroad car companies. Chairman Weatherwax explained his view that the indefinite-situs tax creates an economic disincentive for railroad car companies to bring railroad cars into Indiana, and that this hurts Indiana businesses that repair and perform maintenance on railroad cars. He also explained that the tax revenue is currently used to provide a portion of the funding for the Northern Indiana Commuter Transportation District ("NICTD").

Representative Earl Harris testified before the Commission concerning the importance of the South Shore Railroad to northern Indiana. Representative Harris noted that interested parties have been discussing the issues related to the indefinite-situs tax, with the goals of diminishing the economic disincentive from the indefinite-situs tax and ensuring the continued operation of the South Shore Railroad.

Representatives of the East Chicago Chamber of Commerce, the South Shore Railroad, and a railroad car company also testified on the issue. These witnesses made the following points in their testimony:

- (1) railroad car companies are challenging Indiana's indefinite-situs tax under the federal "4R Act", which governs property taxation of railroads;
- (2) there have been proposals to shift the funding of the South Shore Railroad from the indefinite-situs tax to a very small percentage of the state sales tax, which would protect the funding of the South Shore Railroad if the litigation challenging the tax is successful;
- (3) no other state has an indefinite-situs tax on railroad cars that has the same impact as Indiana's on the number of railroad cars that come into the state; and
- (4) to lower the disincentive for railroad car companies to bring their railroad cars into Indiana for repair, a property tax credit should be established for railroad car maintenance facilities.

D. FOURTH MEETING (October 28, 1998):

School Property Taxes

Senator Weatherwax stated that he hoped to address two issues: (1) the elimination of school general fund and transportation fund property taxes; and (2) how to respond to any shifting of the property tax burden onto homeowners if the Indiana Supreme Court decides the *Town of St. John* case by requiring some form of market value

assessment. He noted that the most recent studies had estimated that market value assessments would lead to an approximately 31% increase in the property tax burden of homeowners. He explained that this would represent an increase of almost \$569 million in property taxes, which is roughly equivalent to the school general fund and school transportation fund property taxes that will be paid by homeowners in 2000. Senator Weatherwax stated that the elimination of school general fund and transportation fund property taxes would therefore hold homeowners harmless from any burden-shifting resulting from market value assessments.

He then discussed how the approximately \$1.5 billion in revenue lost from the elimination of school general fund and transportation fund property taxes could be replaced. For purposes of discussion by the Commission, Senator Weatherwax described a proposal that would replace the lost property tax revenue by increasing various state taxes. Under this proposal: (1) the individual adjusted gross income tax rate would be increased from 3.4% to 3.9%; (2) the corporate adjusted gross income tax rate would be increased from 3.4% to 4.2%; (3) the supplemental net income tax rate would be increased from 4.5% to 5.3%; (4) the financial institutions tax rate would be increased from 8.5% to 8.6%; (5) the sales tax rate would be increased from 5.0% to 5.5%; and (6) the sales tax would be extended to services other than medical and legal services.

The Commission's staff then discussed a memorandum they had prepared describing the potential property tax savings from the elimination of school general fund and transportation fund property tax levies and also specifying how much replacement revenue would be generated by the proposed increases in state tax rates.

After a discussion of the memorandum by Commission members, Senator Richard Young stated that he was concerned with replacing school general fund and transportation fund property taxes with increased state taxes, because the state taxes are more sensitive to changes in the economy. He questioned what would be done during a recession to ensure that education funding did not suffer. Representative Jim Buck commented that he believed Senator Young's concerns were valid, but suggested that a state "rainy day fund" for education funding could be established.

Representative Buck stated that a fundamental issue is whether the replacement revenue should be raised through local taxes or through state taxes, and he said that he believed control over the level of taxation for education should be a local decision. He suggested that a local income tax for education might be the best way in which to replace revenue lost from the elimination of school general fund and transportation property taxes. Senator Young noted that local income taxes for education had been proposed in the past. He stated that some school districts could generate the necessary revenue, but in poorer counties it would take a high local income tax rate to generate that revenue. Representative Buck stated that this problem could be addressed by changing the state school funding formula to provide that the state would pay for shortfalls in school districts that could not raise sufficient revenue.

Representative William Friend asked staff several questions concerning the proposal to expand the sales tax to include services. He also asked how much revenue would be generated by raising the sales tax rate from 5.0% to 5.5%, but not expanding the sales tax base to include services. The Commission's fiscal analysts stated that such an increase in the rate would most likely raise between \$400 million and \$450 million.

Representative Buck noted that the proposal being discussed by the Commission was on its face revenue neutral, but that it did not factor in additional tax revenue that would be generated by the increase in economic activity that would result from the elimination of school general fund and transportation fund property taxes, especially the elimination of the school property taxes that had been imposed on business inventory.

Taxation of Railroad Car Companies

The Commission again discussed and heard testimony on issues related to the taxation of railroad car companies.

Senator Weatherwax discussed Preliminary Draft 3620, which included provisions that would do the following:

- (A) Provide that the property taxes derived from indefinite-situs distributable property of railroad car companies are deposited in the State General Fund, instead of the Commuter Rail Service Fund.
- (B) Grant railroad car companies a credit against their indefinite-situs property tax liability for railroad car maintenance and improvement expenditures made in Indiana. This credit would be equal to 50% of the qualified expenditures made by the taxpayer in the taxable year.
- (C) Provide that 0.17% of state sales tax revenue is distributed to the Commuter Rail Service Fund. This would be roughly equal to what the Northern Indiana Commuter Transportation District ("NICTD") currently receives from property taxes deposited into the Commuter Rail Service Fund.

Senator Weatherwax stated that the draft would remove the indefinite-situs property tax as a source of NICTD funding, and it would also provide an incentive for railroad car companies to expand their business in Indiana, thereby creating more jobs. Senator Weatherwax stated that he believed that the credit would lead to greater railroad car maintenance and repair activity and higher employment, which would in turn generate tax revenue that would at least partially pay for the cost of the credit.

A representative of the East Chicago Chamber of Commerce stated that he supported the proposal and that he believed the property tax credit would prove to be a useful economic development tool. A representative of the General Electric Rail Car Company stated that he also supported the proposal, and he commented that the

current tax structure provides a disincentive that deters railroad car companies from bringing railroad cars into Indiana for repair. A representative of the Indiana Transportation Association, representing NICTD, stated that NICTD also supported the proposal.

E. FIFTH MEETING (November 18, 1998):

State and Local Expenditures and Revenue

Senator Weatherwax recognized Representative Jeff Espich for a discussion of issues related to state expenditure limitations and property tax relief. Representative Espich began his testimony by stating that he believed the General Assembly did not need to increase taxes in order to pay for property tax relief. According to Representative Espich, property tax reduction could be paid for through a combination of three items: (1) revenue enhancements that had been adopted during the preceding decade; (2) greater efficiency and accuracy in budgeting; and (3) the structural surplus in the state budget.

Representative Espich noted that the state now receives nearly \$400 million each year from the lottery and from gambling taxes that it did not receive ten years ago. He also stated that the income tax had been increased 0.4% to pay for the "A+ Program", and that this tax increase now raises over \$400 million per year while the annual program costs are slightly less than \$200 million. Representative Espich also pointed out that approximately \$200 million in appropriations had been reverted during the preceding state fiscal year, which is \$150 million more than was estimated by the State Budget Agency when the budget was passed.

Representative Espich also described proposals to: (1) cut 5%, or \$71.7 million each year, from the administrative operating base of state government; and (2) make additional state money available for tax relief purposes by limiting the growth in state spending below the historic average. He commented that consolidation of various state agencies into the Family and Social Services Administration had been a successful consolidation of state government operations, and he suggested that money could also be saved by the consolidation of certain other state functions into a Public Safety Administration, an Office of Administration and Budget, and a Department of Motor Vehicles.

Representative Espich next described additional budget efficiency proposals concerning: (1) the establishment of an innovation fund to provide a reward for innovative cost-saving suggestions by agencies or individuals; and (2) a review of state government to determine where competitive bidding or other private sector competition could save money. Representative Espich then explained a number of scenarios concerning limits on the rate of growth of state government expenditures.

Senator Weatherwax next recognized Mr. Jim Knoop of the Indiana Policy Review. Mr.

Knoop provided the Commission with written material describing property tax increases in Indiana over the period 1982 - 1997. He also provided the Commission with information on increases in state appropriations during the past ten years. Mr. Knoop began his testimony by noting that during the period 1982 through 1997, property tax revenue had increased 166%, although the Consumer Price Index had increased only 66.3%. Mr. Knoop explained that much of this growth in property tax revenue had resulted from the generally favorable economic conditions since 1982, and he pointed out that assessed valuation had increased 103.9% during that period. He also commented that in every year since 1982, total property tax levies had grown faster than the annual increases in the Consumer Price Index.

Mr. Knoop then reviewed the history of state appropriations during the past ten years. He began by explaining that in 1989 the total state appropriations were approximately \$8.224 billion, but that by 1998 state appropriations had increased by \$5.625 billion to approximately \$13.849 billion. He stated that this amounted to a 68% increase in appropriations during the past ten years, while the Consumer Price Index had increased only 39% during that period. Mr. Knoop also noted that this increase in state appropriations had occurred without any rate increases in the major state taxes. He commented that in every year during the past decade, except for 1995, the annual increase in state spending had been greater than the growth of the Consumer Price Index.

Taxation of Railroad Car Companies

The Commission discussed and voted to recommend PD 3620, concerning the taxation of railroad car companies. During the discussion, Senator Weatherwax commented that the draft would provide an incentive for railroad car maintenance companies to expand their business in Indiana, thereby creating more jobs.

School Property Tax Issues

Representative Jim Buck explained PD 3747, which contained a school property tax relief proposal described by Representative Buck at the Commission's meeting on October 28, 1998. This proposal would do the following:

- (1) Eliminate the authority of a school corporation to impose a general fund property tax levy for the general operation and maintenance of the school corporation.
- (2) Eliminate the authority of a school corporation to impose a transportation fund property tax levy.
- (3) Require a school corporation to impose a local income tax for education of not more than 0.6%.

(4) Limit annual increases in state expenditures to the lesser of: (a) the increase in inflation and population; or (b) 4%.

(5) Limit annual increases in appropriations of political subdivisions, including school corporations, to the lesser of 4% or the percentage changes in population and inflation.

(6) Provide a state tuition support formula that provides an amount equal to the difference between: (a) the school corporation's ADM multiplied by \$5,000; and (b) the amount that the school corporation can raise from a local income tax on education of 0.6% and from certain other revenue sources.

(7) Establish the state school reserve fund and appropriate \$150,000,000 to the fund from the state general fund.

A representative of the Indiana Farm Bureau stated that while he had not gone through the details of the proposal, the Indiana Farm Bureau did support the principle of replacing school general fund property taxes with a local income tax for education. He also commented that such a local income tax would much better reflect a taxpayer's ability to pay and that 1998, a year in which commodity prices received by farmers were extremely low, highlighted the unfair impact property taxes had on farmers.

A number of Commission members questioned Representative Buck concerning the disparities between different school districts' ability to raise the necessary revenue through a local income tax. Representative Buck responded that the tuition support formula would be structured to make up the difference between: (1) what the school corporation could raise through a local income tax; and (2) an amount equal to \$5,000 per student.

A representative of the Indiana Chamber of Commerce testified that, while he had not reviewed the details of the draft, the Chamber agreed with the principle of achieving property tax reform by eliminating entire property tax levies. He stated that the elimination of entire property tax levies was the best way to ensure that any property tax reform was permanent.

A representative of the Indiana Association of Cities and Towns testified that the spending controls included in the proposal were not wise or workable with respect to municipalities, and that local elected officials should make the expenditure decisions. He stated that there are different revenue sources for local governments and for the state, and that the spending of most municipalities is effectively restrained by the limitations placed on their revenue growth.

He also explained that cities and towns represent approximately 16% of statewide property taxes, and he commented that the Consumer Price Index, which the proposal uses as a factor in determining allowable expenditures, is not a good measure of cost increases incurred by local governments.

Senator Weatherwax then briefly described a property tax relief proposal he had put forward for discussion at the Commission's previous meeting. That proposal would do the following:

- (1) Eliminate the authority of a school corporation to impose a general fund property tax levy for the general operation and maintenance of the school corporation.
- (2) Eliminate the authority of a school corporation to impose a transportation fund property tax levy.
- (3) Increase the individual adjusted gross income tax rate from 3.4% to 3.9%.
- (4) Increase the corporate adjusted gross income tax rate from 3.4% to 4.2%.
- (5) Increase the corporate supplemental net income tax rate from 4.5% to 5.3%.
- (6) Increase the financial institutions tax rate from 8.5% to 8.6%.
- (7) Increase the sales tax rate from 5.0% to 5.5%, and extend the sales tax to services other than medical and legal services.

Mr. Michael Claytor, a lay member on the Commission, stated that he believed property tax reduction was a good idea, but that its effect on the use of tax increment financing as an economic development tool needs further study. He noted that any reduction in property taxes would reduce the economic value of the tax increment. He also commented that he believed many units of local government were in fact doing a good job of keeping their property taxes from increasing. Representative Leuck noted that according to projections of the overall tax burden under PD 3739, homeowners and farmers, as an aggregate category, would pay more.

After further Commission discussion, a motion was made and seconded to recommend that as part of any discussions concerning tax restructuring, the General Assembly should also consider the option of: (1) authorizing a local income tax for education; and (2) eliminating school general fund and transportation property tax levies. The proposed recommendation was adopted 7-0.

V. COMMISSION RECOMMENDATIONS

The Commission made the following recommendations:

(1) The Commission voted 6-0 to recommend PD 3050 to the General Assembly. This draft would phase-in a credit against state taxes for property taxes paid on inventory.

(2) The Commission voted 6-0 to recommend a proposed Joint Resolution to the General Assembly. This proposed resolution would amend the Indiana Constitution to allow the General Assembly to exempt business inventory from property taxation.

(3) The Commission voted 7-0 to recommend PD 3620 to the General Assembly. This draft would do the following:

(A) Provide that the property taxes derived from indefinite-situs distributable property of railroad car companies are deposited in the State General Fund, instead of the Commuter Rail Service Fund.

(B) Grant railroad car companies a credit against their indefinite-situs property tax liability for railroad car maintenance and improvement expenditures made in Indiana. This credit would be equal to 50% of the qualified expenditures made by the taxpayer in the taxable year.

(C) Provide that 0.17% of state sales tax revenue is distributed to the Commuter Rail Service Fund. This would be roughly equal to what the Northern Indiana Commuter Transportation District currently receives from property taxes deposited into the Commuter Rail Service Fund.

(4) The Commission voted 7-0 to recommend that as part of any discussions concerning tax restructuring, the General Assembly should also consider the option of: (A) authorizing a local income tax for education; and (B) eliminating school general fund and transportation property tax levies.

APPENDIX 1

Synopses of Proposed Legislation Recommended by the Commission

PD 3050: Tax credit for inventory tax payments. Provides a credit against a taxpayer's state tax liability for property taxes paid on inventory. Provides that the credit is initially equal to 10% of property taxes paid on inventory, and increases the credit percentage over ten years until the credit may be claimed for 100% of property taxes paid on inventory.

Proposed Joint Resolution to Amend the Indiana Constitution: Assessment and taxation of inventory. Allows the General Assembly to enact a law to exempt inventory from property taxation.

PD 3620: Taxation of railroad car companies. Provides that the property taxes derived from indefinite-situs distributable property of railroad car companies shall be deposited in the state general fund, instead of the commuter rail service fund. Provides that 0.17% of state sales tax revenue shall be distributed to the commuter rail service fund. Grants railroad car companies a credit against indefinite-situs property tax liability for railroad car maintenance and improvement expenditures made in Indiana. Provides that the credit is equal to 50% of the qualified expenditures made by the taxpayer in the taxable year.

WITNESS LIST

July 9, 1998

No witnesses; staff presentations only.

July 21, 1998

Professor Larry DeBoer, Purdue University
William Styring, Hudson Institute
Edward Bowman, National Federation of Independent Business

September 15, 1998

Don Coover, Committee to Restore Indiana Property Tax Controls
Kevin Brinegar, Indiana Chamber of Commerce.
Representative Earl Harris
Rex Richards, East Chicago Chamber of Commerce
Gerald Hanas, South Shore Railroad
Mr. Zwartz, Union Tank Car Company.

October 28, 1998

Mr. Rex Richards, East Chicago Chamber of Commerce
Louis Mazucca, General Electric Rail Car Company
Kent McDaniel, Indiana Transportation Association

November 18, 1998

Representative Jeff Espich
Mr. Jim Knoop, Indiana Policy Review
Mr. Robert Kraft, Indiana Farm Bureau
Mr. Kevin Brinegar, Indiana Chamber of Commerce
Mr. Tom Morton, Indiana Association of Cities and Towns